DEPARTMENT OF STATE REVENUE

02-20140385.LOF

Letter of Findings: 02-20140385
Corporate Income Tax
For the Years 2009, 2011, and 2012

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.

ISSUES

I. Corporate Income Tax - Research Expense Credits.

Authority: IC § 6-3.1-4-1; IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 2012); Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138 (Ind. Tax Ct. 2010); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer argues that the Department erred when it denied Taxpayer the benefit of certain research expense credits.

II. Corporate Income Tax - Consolidated Filing.

Authority: IC § 6-3-2-1(b); IC § 6-3-2-2; IC § 6-3-2-2(l); IC § 6-3-2-2(m); IC § 6-3-4-1(3); IC § 6-3-4-14; IC § 6-3-4-14(b); IC § 6-8.1-5-1(c); Dept. of State Revenue v. Caterpillar, Inc., 2014 WL 4187800 (Ind. 2014); Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999); 45 IAC 3.1-1-111.

Taxpayer maintains that it is entitled to include a particular entity in its consolidated income tax filing and that the Department's decision removing the entity from the return was wrong.

III. Corporate Income Tax - Business and Non-Business Income.

Authority: IC § 6-3-1-20; IC § 6-3-1-21; IC § 6-3-2-2(b); IC § 6-3-2-2(g)-(k); IC § 6-8.1-5-1(c); May Dept. Stores Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001); 45 IAC 3.1-1-29; 45 IAC 3.1-1-30; 45 IAC 3.1-1-38; MTC Regs. IV.1.(c).(3); Hellerstein, State Taxation: Corporate Income and Franchise Taxes, 2nd ed. ¶ 9.10.

Taxpayer states that interest income earned on PIK notes received as partial proceeds on the sale of its grain elevator operation is non-business income.

STATEMENT OF FACTS

Taxpayer is in the business of producing and packaging food products. Taxpayer operates multiple business locations within Indiana and outside Indiana. The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns. The audit resulted in the assessment of additional corporate income tax for the years 2009, 2011, and 2012. No assessment was made for the year 2010.

Taxpayer disagreed with a portion of the assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Corporate Income Tax - Research Expense Credits.

DISCUSSION

The issue is whether Taxpayer is entitled to a research expense credit against the tax liability of one of Taxpayer's related entities.

Taxpayer claimed research expense credits for research work purportedly performed at its Indiana manufacturing

locations. The audit found that Taxpayer's research work was performed by a separate entity here designated as "Enterprise Entity." As explained by the audit report:

> It appears, the research and development activities in the Indiana plants during the audit period is within the purview of the [Enterprise Entity] mandate and therefore, would constitute as a contract research by [Enterprise Entity] reimbursed by [Research Entity].

The audit concluded that Taxpayer could not claim the credits:

> [Research Entity] has no activities in Indiana and is not included in the consolidated IT20 and therefore has no adjusted gross income tax liability. [Research Entity] therefore cannot claim Indiana R&D credit. Neither can [Enterprise Entity] claim R&D credit because it is reimbursed for its R&D expenses by [Research Entity].

The audit report cited to IC § 6-3.1-4-1 as a basis for its decision disallowing the credits.

> "Research expense tax credit" means a credit provided under this chapter against any tax otherwise due and payable under IC 6-3. "Taxpayer" means . . . a corporation . . . that has any tax liability under IC 6-3 (adjusted gross income tax).

In effect, the audit found that, (1) Research Entity was not entitled to claim the research expense credit because Research Entity "has no activities in Indiana and is not included in the consolidated IT20 and therefore has no adjusted gross income tax liability. [Research Entity] therefore cannot claim Indiana R&D credit." The audit also found that, (2) Enterprise Entity could not claim the research expense credits "because it is reimbursed for its R&D expenses by [Research Entity]."

However, Taxpayer argues that the audit partially misunderstood the basis for the claim. Although Taxpayer concedes that it is not entitled to claim credits based upon research conducted by Enterprise Entity, Taxpayer indicates that it is entitled to claim credits valued at approximately $92,000 based upon activities performed by "Holdings." Taxpayer explains that "[t]he research and development activities in Indiana manufacturing plants are incurred by [Holdings], an Indiana taxpayer, and related to manufacturing improvement processes undertaken by [Holdings] in its activities as a contract manufacturer." Taxpayer further explains, "[T]hese projects enable [Holdings] to improve its manufacturing processes to become more efficient and competitive as a contract manufacturer."

According to Taxpayer, the result is that - although it is contesting the disallowance of the full $300,000 in credits originally claimed, it asserts that it is entitled to claim a lesser amount of credit - approximately $92,000 - based on Holdings' research activities conducted during 2009, 2011, and 2012.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Thus, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Poorly developed and non-cogent arguments are subject to waiver. Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012).

Taxpayer provided schedules detailing the qualified research expenses incurred by Holdings in Indiana and a copy of the letter from the IRS indicating the federal returns reporting these qualified research expenses were accepted as filed under the IRS' Compliance Assurance Program ("CAP"). According to Taxpayer, under the CAP program, participating corporate taxpayers' return preparation processes are audited during the preparation and completion of the returns and the tax periods are generally considered closed once the returns are accepted by the IRS.

The audit was correct in denying Taxpayer the research expense credits based upon the information initially provided at the time of the audit review. However, Taxpayer has provided additional information relative to research expense credits generated on behalf of Taxpayer by Holdings. Unlike Research Entity and Enterprise Entity, Holdings' R&D activities appear to meet the statutory criteria entitling Taxpayer to claim those credits. Therefore, subject to the Audit Division's review and acceptance of the newly submitted financial documentation, Taxpayer's protest is sustained in part.

FINDING

Subject to the Audit Division's verification, Taxpayer's argument - that it is entitled to research expense credit based on research activities performed by Holdings - is sustained.

II. Corporate Income Tax - Consolidated Filing.

DISCUSSION

The issue is whether one of Taxpayer's related companies - here designated as "Food Entity" - should be included in Taxpayer's consolidated return.

Taxpayer filed consolidated income tax returns. In that return, Taxpayer included Food Entity. According to the audit report:

> Following the sales of the trading and merchandising operations in FY 2009, [Food Entity] no longer has Indiana property, payroll or sales for the fiscal years 2011 and 2012. Because of this [Food Entity] can no longer be included in the Indiana consolidated IT20 return as it no longer has "adjusted gross income derived from sources within the state."

The audit report stated:

> The Taxpayer in an effort to show that [Food Entity] does business in Indiana provided documentation to show its employees visiting the Indiana plants providing services to affiliates doing business in Indiana. It appears that such services are part of its oversight as the parent company. It is noted that such oversight duties are mostly performed at its head office [outside Indiana]. It is the opinion of this audit that the oversight activities performed in Indiana are d[e] minimus and would not be enough to create an income tax-filing requirement in Indiana.

As authority for its decision, the audit report cited to the Department's regulation, 45 IAC 3.1-1-111 which states:

> The Adjusted Gross Income Tax Act adopts the definition of "affiliated group" contained in Internal Revenue Code section 1504, except that no member of the affiliated group may be included in the Indiana return unless it has adjusted gross income derived from sources within the state, as that phrase is defined in IC 6-3-2-2. For purposes of this subsection, "Adjusted Gross Income derived from sources within the state" means either income or losses derived from activities within the state. (Emphasis in original audit report).

Taxpayer argues that Food Entity performs services in Indiana for "Holdings." According to Taxpayer, Food Entity's employees visit Indiana manufacturing locations which are activities which "go beyond sales solicitation." Taxpayer explains that the visits are "not di minimus in amount" and that these visits do "create nexus with Indiana for income tax reporting purposes . . . ." In support of its argument, Taxpayer provided employee job descriptions which set out individual employee responsibilities including on-site visits to the Indiana manufacturing locations. In addition, Taxpayer provided documentary evidence purporting to establish that, during the years at issue, Food Entity's employees stayed at Indiana hotels 155 days. Taxpayer explains that Food Entity's employees perform "executive management, finance, accounting, payroll, legal, tax, human resources, internal audit . . . aircraft, investor relations, treasury and risk managements" at three of Taxpayer's plants but notes that most of these services are performed at its out-of-state headquarters.

Over-and-above the employees' activities, Taxpayer explains that Food Entity is paid service revenue a portion of which "is for its 'services rendered within this state.'" Taxpayer also states that these "intercompany revenues are ultimately eliminated in consolidation for apportionment calculation purposes" but that, nonetheless, Food Entity "did incur income or losses derived from activities within the state of Indiana."

Taxpayer concludes:

> [Food Entity] has "adjusted gross income from sources within the state of Indiana", because [Food Entity] has income from "doing business" in Indiana under IC 6-3-2-2(a)(2), as defined under 45 IAC 3.1-1-38(4) and (7), because it renders services to [Holdings] in Indiana, and because it performs acts in Indiana which exceed the mere solicitation of orders so as to give the state nexus under P.L. 86-272 to tax its income. Therefore, because [Food Entity] is doing business in Indiana under IC 6-3-2-2(a)(2) and 45 IAC 3.1-1.38, and because

> it receives compensation for labor or services rendered within this state under IC 6-3-2-2(a)(4), [Food Entity] should be included in the Indiana consolidated returns at issue.

As noted in Part I above, it is the Taxpayer's responsibility to here establish that the tax assessment is incorrect. "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC § 6-8.1-5-1(c). In addition, the Indiana Supreme Court has stated that, as the agency enforcing Indiana tax law, the Department's "reasonable interpretation of [a] statute" is entitled to deference "even over an equally reasonable interpretation of another party." Dept. of State Revenue v. Caterpillar, Inc., 2014 WL 4187800, at 2 (Ind. 2014).

Taxpayer maintains that Food Entity performs various activities in Indiana which would entitle it to be included in the consolidated return. The relevant statute is IC § 6-3-4-14 which provides in part:

> (a) An affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC 6-3. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all of the provisions of this section including all provisions of the consolidated return regulations prescribed pursuant to Section 1502 of the Internal Revenue Code and incorporated herein by reference and all regulations promulgated by the department implementing this section prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.
>
> (b) For the purposes of this section the term "affiliated group" shall mean an "affiliated group" as defined in Section 1504 of the Internal Revenue Code with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana.
>
> (c) For purposes of IC 6-3-1-3.5(b), the determination of "taxable income," as defined in Section 63 of the Internal Revenue Code, of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, shall be determined pursuant to the regulations prescribed under Section 1502 of the Internal Revenue Code.
>
> (d) Any credit against the taxes imposed by IC 6-3 which is available to any corporation which is a member of an affiliated group of corporations making a consolidated return shall be applied against the tax liability of the affiliated group. (Emphasis added).

As explained by the Tax Court in Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766, 780 (Ind. Tax Ct. 1999), "Under section 6-3-4-14, members of an affiliated group may file a consolidated return. One caveat is that each member must have adjusted gross income from sources within Indiana."

Corporations that have taxable nexus in Indiana are those corporations that have "adjusted gross income from sources within the state of Indiana." IC § 6-3-2-1(b); IC § 6-3-4-1(3). For a corporation to have "adjusted gross income from sources within the state of Indiana," the corporation must have either Indiana apportionment factors to have deemed Indiana business income or non-business income that is allocated to Indiana. IC § 6-3-2-2.

Taxpayer argues that the presence in Indiana and the activity in Indiana of Food Entity's representatives create taxable nexus for purposes of the state's adjusted gross income tax. Under Indiana law, are the activities performed by Food Entity's employees sufficient to justify including Food Entity in the consolidated return? The Department is unable to agree because, under IC § 6-3-4-14(b), merely having nexus with the state is insufficient to bring an entity into the consolidated group. IC § 6-3-4-14(b) requires that the Food Entity have "adjusted gross income derived from sources within the state."

However, Taxpayer points out that Food Entity provides services to Holdings and receives money for doing so. Taxpayer admits that this particular stream of income is "ultimately eliminated in consolidation for apportionment purposes" but believes that this is a distinction without a difference. Taxpayer stands by its position that income purportedly earned by Food Entity from Holdings constitutes "income or losses derived from activities within the state of Indiana" and that, under IC § 6-3-4-14(b), Food Entity should be included in the consolidated return.

Taxpayer explains that the putative Indiana income is "eliminated" for apportionment purposes but has failed to

establish the amount of adjusted gross income earned for performing the oversight activities conducted by Food Entity. Further, Taxpayer has failed to establish the amount of money which is earned for performing oversight services in Indiana and the amount of money which is earned by Food Entity for performing oversight activities at its out-of-state headquarters.

In addition, Taxpayer has failed to address the audit's conclusion that "[Food Entity] should be removed from the adjusted gross income tax computation to fairly reflect its Indiana source income." (Emphasis added). The audit relies on the Indiana law provision which states:

> If the allocation and apportionment provisions of this article do not represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
> (1) separate accounting;
> (2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or (4) the employment of any other method effectuate an equitable allocation and apportionment of the taxpayer's income. IC § 6-3-2-2(l).

The audit found that Food Entity's oversight were de minimus and are insufficient to create an income tax-filing requirement in Indiana. In other words, based on Food Entity's de minimus - and somewhat ambiguous - Indiana activity, including Food Entity in the consolidated return, would have an outsized and disproportionate effect and "would not fairly reflect . . . the income derived from sources within the state of Indiana . . . ." IC § 6-3-2-2(m).

For these reasons, the Department concludes that Taxpayer has failed to meet its burden under IC § 6-8.1-5-1(c) of establishing that the audit's decision excluding Food Entity from the consolidated return was "wrong."

FINDING

Taxpayer's protest is respectfully denied.

III. Corporate Income Tax - Business and Non-Business Income.

DISCUSSION

The issue is whether interest income derived from Payment in Kind ("PIK") notes received from the voluntary divestiture of Taxpayer's grain elevator operation constitutes business or non-business income.

A. Taxpayer's Divestiture of Business Assets.

Taxpayer operated three major business segments. Included in one of the three business segments was a business here referred to as "Merchandising Business." Merchandising Business was previously engaged in domestic and international grain merchandising, fertilizer distribution, agricultural and energy commodity trading and services, and grain, animal and oil seed byproduct merchandising and distribution. Merchandising Business was also involved in the natural gas and crude oil business.

In fiscal year 2009, Taxpayer sold its Merchandising Business which was accomplished in a series of stock transactions treated as the sale of assets. Taxpayer received cash, four year "payment in kind" (PIK) notes, a short term note, and a four year warrant to acquire equity of the Merchandising Business buyer. The PIK notes were issued to Taxpayer as partial compensation for the sale of grain elevators included in the overall 2009 divestiture.

Taxpayer earned interest income from the PIK notes. In its original tax return, Taxpayer declared the PIK interest income as non-business income on the ground that it is not in the business of investing in PIK notes or of selling interests in grain elevators. According to the audit report, Taxpayer argued that the acquisition of the PIK notes is a non-business activity under the functional test.

Taxpayer also asserts that the interest from the PIK notes is entitled to non-business income treatment under the transactional test because the sale of the grain elevators and the acquisition of notes receivable were not in the regular course of Taxpayer's food production and food packaging business.

B. Taxpayer's Arguments.

Taxpayer differentiates between proceeds from the sale of the grain elevators and interest income from the PIK notes:

> The original divestiture of the grain elevators was an extraordinary event - outside of normal business operations. [Taxpayer] did not divest its grain elevators as a part of its normal business operations - the divestiture of its grain elevators terminated its grain elevator business. So the gain on the sale of the grain elevators was not business income under the transactional test. However, because the grain elevator assets had been operated as a part of the business up until the divestiture, the gain on the grain elevators was considered business income under the functional test. In contrast however, the [] PIK Notes that were received as sales proceeds - in an extraordinary transaction - were assets a step further removed from the grain elevator operations. The PIK notes were held only as investments and had no operational connection whatsoever to the normal ongoing business operations. Therefore, the interest earned on the PIK notes is nonbusiness income under both the transactional test and the functional test. (Emphasis omitted).

Taxpayer emphasizes that:

> [T]he interest income earned on the PIK Notes did not arise in the normal course of the taxpayer's business, therefore, it is not business income under the transactional test. In addition, the "acquisition, management, and disposition" of the PIK Notes did not constitute an "integral part" of the taxpayer's regular trade or business operations. The Notes were received in an extraordinary business-terminating transaction. Moreover, the PIK Notes were not "used by the taxpayer in its regular trade or business operations", as they were never pledged as security for loans, or used in any other way for business purposes in Indiana.

Taxpayer concludes that:

> [T]he PIK Notes were passive investments acquired in a divestiture transaction. Moreover . . . the U.S. Supreme Court states that it does not matter how the passive investment asset was acquired; if an asset is not unitary, how that asset is acquired does not change the asset from being a passive investment into an integral operational asset. The key is whether the assets generating the income (the PIK Notes, in this instance) are unitary with the business conducted in Indiana. Subsequent to the consummation of the divestiture, the prior grain elevator business is not unitary with the ongoing operations in Indiana, and therefore the subsequent interest earned on the Notes is not apportionable by Indiana.

C. Audit Conclusion.

The audit disagreed as follows:

> The exchange of the PIK notes and the [Merchandising Business assets] should be viewed under the overall package of the sales of the [Merchandising Business]. The Taxpayer buys and sells businesses all the time and therefore, under the functional test, [the exchange of PIK notes] should be considered business income.

The audit noted that, based on Taxpayer's 10K reports, during 2009 through 2012, Taxpayer acquired eight different business operations. The audit also noted that during 2007 and 2011, Taxpayer divested or sold eight other businesses.

The audit concluded:

> Since the PIK notes were acquired in the regular course of the Taxpayer's trade or business, it is considered a business asset whose income would be considered business income . . . It appears that when a business asset that produces business income when exchanged for another income-producing asset such as a note receivable, such asset and the income it produces should also be considered business income.

At the outset, the Department rejects Taxpayer's contention that - for purposes of distinguishing business and non-business income - there is a substantive difference between the money obtained in the form of the original PIK notes and interest earned on those notes. To that end, the Department finds the Multistate Tax Commission ("MTC") regulation squarely on point.

> Interest income is business income where the intangible with respect to which the interest was received arose out of or was created in the regular course of the taxpayer's trade or business operations or where the

acquiring and holding the intangible is an integral, functional, or operative component of the taxpayer's trade or business operations, or otherwise materially contributes to the production of business income of the trade or business operations. MTC Regs. IV.1.(c).(3).

The Department recognizes that the MTC regulations are not binding because Indiana is not a member of the MTC compact. Nevertheless, the regulation cited offers useful guidance in resolving competing interpretations of the statutory apportionment scheme.

In addition to the MTC regulation noted above, the statutory definition contained in the Uniform Division of Income for Tax Purposes Act (UDITPA) provides that interest income is business income if the underlying intangible was acquired, maintained, and disposed of as an integral part of the taxpayer's trade or business. See Hellerstein, State Taxation: Corporate Income and Franchise Taxes, 2nd ed. ¶ 9.10.

That being said, the issue is whether Taxpayer's money earned from the PIK notes is business income under IC § 6-3-1-20. Taxpayer argues the interest income represents allocable non-business income. The Department, on the other hand, contends this income represents business income subject to apportionment. Resolution of the legal issue depends on whether the income derived from PIK notes meets the IC § 6-3-1-20 definition of "business income." Specifically, resolution depends on whether the aforementioned interest income qualifies as business income under either the functional test or the transactional test.

For purposes of determining a taxpayer's adjusted gross income tax liability, "business income" is apportioned between Indiana and other states. IC § 6-3-2-2(b). In contrast, "non-business income" is wholly allocated to Indiana, or wholly allocated to another state. IC § 6-3-2-2(g) to (k). Therefore, "whether income is deemed business income or non-business income determines whether it is allocated to a specific state or whether it is apportioned between Indiana and other states [in which] the taxpayer is conducting its trade or business." May Dept. Stores Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651, 656 (Ind. Tax Ct. 2001). See also 45 IAC 3.1-1-38 (defining "doing business").

D. Business Income.

Under IC § 6-3-1-20, business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations."

Indiana's regulations expand on this definition. 45 IAC 3.1-1-29. Under this regulation, "the critical element in determining whether income is 'business income' or 'non-business income' is identification of the transactions and activity which are the elements of particular trade or business." Id. In contrast, "[t]he classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating income, etc., is of no aid in determining whether income is business or non-business income." Id. In other words, whether income is derived from manufacturing cars, providing personal services, buying and selling real estate, managing intellectual property, or any other "type" or "category" is not relevant.

Furthermore, "[f]or purposes of determining whether income is derived from an activity which is in the regular course of the taxpayer's trade or business, the expression 'trade or business' is not limited to the taxpayer's corporate charter purpose of its principal business activity. A taxpayer may be in more than one trade or business, and derive business therefrom depending upon but not limited to some or all of the following:

(1) The nature of the taxpayer's trade or business.

(2) The substantiality of the income derived from the activities and the percentage that income is of the taxpayer's total income for a given tax period.

(3) The frequency, number of continuity of the activities and transactions involved.

(4) The length of time the property producing income was owned by the taxpayer.

(5) The taxpayer's purpose in acquiring and holding the property producing income.

45 IAC 3.1-1-30

E. Non-business Income.

Non-business income is defined in the negative. Non-business income "means all income other than business income." IC § 6-3-1-21. Non-business income is allocated either wholly to Indiana or wholly to another state. IC § 6-3-2-2(g) to (k).

F. Distinguishing "Business" From "Non-business" Income.

Indiana employs two tests to determine if income is "business" or "non-business." Income qualifies as "business income" if the income satisfies the criteria of either test. The first test, the "transactional test," derives from the statutory language, "income arising from transactions and activity in the regular course of the taxpayer's trade or business . . . ." IC § 6-3-1-20. This test focuses on the nature of the particular transaction. The second test, the "functional test," derives from the statutory language, "income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations." Id. Generally speaking, under the functional test, "all gain from the disposition of a capital asset is considered business income if the asset was used by the taxpayer in its regular trade or business operations." May, 749 N.E.2d at 659-60 (citations and quotations omitted).

1. Transactional Test.

Under the transactional test, "the critical element in determining whether income is 'business income' or 'non-business income' is the identification of the transactions and activity which are the elements of a particular trade or business." 45 IAC 3.1-1-29 (Emphasis added). Gains are classified as business income when they are derived from a transaction in which the taxpayer regularly engages. Under this test, the "controlling factor by which business income is identified is the nature of the particular transaction giving rise to the income." May, 749 N.E.2d at 658 (citing General Care Corp. v. Olsen, 705 S.W.2d 642, 644 (Tenn. 1986)). In deciding whether a specific transaction generated business income, relevant considerations include (1) the frequency or regularity of similar transactions, (2) the previous practices of the business, and (3) the taxpayers' subsequent use of the income. Id. at 659. Citing 45 IAC 3.1-1-30, the court noted that relevant factors to consider in analyzing whether income from the disposition of an asset is business or non-business income include the following: (1) the nature of the taxpayer's trade or business; (2) the substantiality of the income derived from activities and transactions and the percentage that income is of the taxpayer's total income for a given tax period; (3) the length of time the property producing income was owned by the taxpayer; and (4) the taxpayer's purpose in acquiring and holding the property producing income. May, 749 N.E.2d at 664, n.13.

2. Functional Test.

"The functional test focuses on the property being disposed of by the taxpayer." Id. at 664. Specifically, the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. Id. In order to satisfy this test, the property generating income must have been "acquired, managed, and divested or disposed by the taxpayer" in "a process . . . integral to taxpayer's regular trade or business operations." Id. Furthermore, "[i]t is not enough that the property was used to generate business income for the taxpayer prior to its disposition. The disposition too must be an integral part of the taxpayer's regular trade or business operations." Id. at 664 . The Indiana Tax Court observed in May that while the asset that was disposed of by the taxpayer was "unquestionably an integral part of [the taxpayer's] business operations," the disposition of the asset was pursuant to a court ordered divestiture for the benefit of a competitor and not for the benefit of the taxpayer. Id. at 665. The Court concluded that "[u]nder these circumstances, this divestiture (or disposition of assets) could not have constituted an integral part of [the taxpayer's] regular trade or business operations." Id. at 665. Thus, the court's conclusion that the taxpayer's sale of one of its retailing divisions was not necessary or essential to its regular trade or business, was based, in part, on the fact that the sale was executed pursuant to a court order that benefited a competitor, not the taxpayer. Id. at 665. Since the sale of the department store's division was found to be not a "necessary" or "essential" part of the taxpayer's business, the proceeds from sale of the division were not business income under the functional test. Id. Accordingly, though not dispositive standing alone, whether the income derived from the disposition benefited the taxpayer's trade or business or in reality, benefited a third-party, and whether the transaction was voluntary or involuntary are relevant factors to consider under the functional test. See Id.

G. Analysis and Conclusion.

The Department concludes that the PIK interest income constitutes business income under the transactional test

because the voluntary acquisition and disposition of business units such as Taxpayer's grain elevator business is a regular and routine part of Taxpayer's overall business operation. As noted at the outset, the audit indicated that over a three-year period, Taxpayer acquired eight different operations and that during a similar four-year period, Taxpayer sold or divested itself of eight other business operations including an amusement park which is plainly not a part of Taxpayer's core food business. The disposition of the grain elevator was not such an extraordinary event that justifies classifying the PIK income as non-business.

Taxpayer states that the PIK notes were received in an "extraordinary business-terminating transaction" and were never "used by the [T]axpayer in its regular trade or business [because] they were never pledged as security for loans, or used in any other way for business purposes in Indiana." Although Taxpayer is silent as to the purpose for which Taxpayer makes use of the PIK income, it is a reasonable - and unrebutted - assumption that the money is used in the day-to-day, normal course of Taxpayer's business further bolstering the argument the PIK interest income is properly classified as business income under the transactional test.

The Department further concludes that the PIK income is also properly classified as business income under the functional test: (1) Taxpayer - as mentioned at the outset - is in the "business of producing and packaging food products." Taxpayer's grain elevator business was an integral part of Taxpayer's food production business; (2) The money earned from the sale of the grain elevator business, while only one portion of Taxpayer's overall income, was neither insubstantial nor inconsequential; (3) Taxpayer's ownership of the grain elevator business was not a brief, insignificant business relationship; Taxpayer held that particular segment of its business in excess of 50 years; and (4) Taxpayer acquired, operated, and held the grain elevator business as an integral part of its core food production business operation.

Taxpayer has failed to meet its burden under IC § 6-8.1-5-1(c) of establishing that the proposed assessment was wrong. Under any reasonable interpretation of the standards at play, the money earned from the voluntary sale of the grain elevator business - including both the PIK notes and the consequent earned interest - is properly classified as business income under both the transactional and functional test.

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

Subject to audit verification, Taxpayer is entitled to claim the research expense credits attributable to Holdings; Taxpayer is not entitled to include Food Entity in its consolidated income tax return; both the PIK notes and the interest earned on those notes are properly classified as business income.

Posted: 12/31/2014 by Legislative Services Agency
An html version of this document.